



Comments from the Federal Ministry for Economic Cooperation and Development on the DEval evaluation report: “Structured Funds – A financing approach in the field of tension between financial sustainability and development impact”

Preface

The Federal Ministry for Economic Development and Cooperation (BMZ) welcomes the report „Structured Funds - a financing approach in the field of tension between financial sustainability and developmental impact“, submitted by the German Institute for Development Evaluation (DEval).

The report analyzes the framework conditions and effects of this financing approach in the context of development cooperation, thus illustrating design options in terms of best practice. The evaluation was included in DEval's rolling multi-year evaluation program at the suggestion of BMZ.

Relevance of the object of evaluation

According to estimates by the United Nations, global investments of up to 4.5 trillion USD are required annually to achieve the Sustainable Development Goals (SDGs) in developing countries. This sum exceeds the annual expenditure for Official Development Assistance (ODA) many times over. Involving private actors to mobilize additional development finance is therefore crucial. In addition, private actors are central drivers of economic development, and their inclusion in development and economic policy is critical to achieve sustainable economic development. Nine out of ten jobs in developing countries are provided by the private sector. But the financing offer for micro, small and medium-sized enterprises (MSMEs) in many developing countries is insufficient. Against this background, the Addis Ababa Action Agenda 2015 calls for more innovative financing mechanisms to be used in order to mobilize additional private funding for sustainable development.

Structured funds are one of these innovative financing mechanisms. Their use in the context of German development cooperation has increased significantly since 2005. The cross-sectional goals that the BMZ is pursuing here are, among others, to mobilize additional funds for development finance and to enhance private sector development. With this market-oriented financing approach, the KfW participates in funds as a trustee on behalf of the BMZ. Further characteristics of structured funds are that both public and private resources are paid into a fund that invests in sectors eligible for development policy, and that public funds bear a higher default and return risk than private funds. The latter serves as an incentive to mobilize private funds for investments in a difficult market environment typical of developing countries. In recent years, structured funds have been the subject of various inquiries from the German Bundestag. In international evaluation research, they are an underrepresented subject of evaluation. The DEval report is the first systematic evaluation of this financing approach for development cooperation.

Results of the evaluation

The evaluation is based on the investigation of ten selected debt capital funds in the MSME financing, renewable energies, environment, agriculture, education, infrastructure sectors with a total volume of more than three billion euros, of which around 700 million euros are federal funds and around 400 million euros KfW own funds. In-depth analyses are based on four funds in the MSME financing area. The evaluation examines the appropriateness of the financing approach - with a view to financial sustainability and development policy orientation, the extent of the mobilization of private funds and the effect on financial intermediaries and end customers.

The following results are of particular interest to the BMZ and are therefore highlighted here:

- *Financial sustainability:* The majority of the funds examined are cost-effective within a few years of being set up, use public funds on a revolving basis and can therefore be classified as financially sustainable. The total expense ratio of the funds examined is well below the industry average. There is further potential for improvement with regard to the design of the risk-return structure.
- *Development policy orientation:* Structured funds show a high degree of agreement with the strategic goals of the BMZ. They work in addition to other approaches and help to build stable and inclusive financial systems. Due to their structure, they can guarantee continuity even in times of crisis such as the current corona pandemic. There is room for improvement in pursuing the goal of reaching end customers and in the targeted use of synergies with country-specific private sector and financial system development measures.
- *Mobilization:* Structured funds are a suitable approach to provide additional capital for the achievement of development policy goals. The funds examined were able to mobilize private capital in a ratio of 1: 1 to the public funds deployed until 2018. There is an untapped mobilization potential that could be opened up by adapting the risk structure and acquisition strategies.
- *Effect on financial intermediaries and end customers:* Structured funds contribute to the stability and financial sustainability of the financial intermediaries and thus the financial systems by providing long-term financing partly in local currency. In addition, they make it easier for end customers to access capital through the increase in the volume of the loans they generate and through capacity development measures financed by structured funds. Improvements in credit conditions or

easier access for groups who previously had no access to finance have rarely been achieved - there is room for improvement here.

Conclusions and recommendations

DEval comes to the conclusion that structured funds are fundamentally suitable for meeting the requirements associated with them, both financially and in terms of development policy. The report summarizes the potential and challenges of structured funds and sends a signal to refine and further develop this approach. As far as further development is concerned, DEval opens, among others, the following perspectives:

- to expand the approach to a greater extent to other sectors worthy of development policy (e.g. climate), in which structured funds can have market-building effects;
- to expand the product range (e.g. to promote more equity funds);
- and to use funds as a stabilizing instrument for financing in riskier markets even in times of crisis.

The BMZ sees itself confirmed by the results of the report in the use of structured funds in development cooperation and will take into account the potential for improvement, recommendations and perspectives shown in the further development of the approach, including also as part of the implementation of the BMZ 2030 concept. It is also planned to anchor the results further within the framework of a "Financial Cooperation with Regions" strategy and an operational guide.

Finally, the recommendations are discussed in detail:

On recommendation 1 - Ensure additionality, efficient functioning and financial sustainability

The results show that a lot has already been achieved in this respect, which can be followed up

by further improvements. On behalf of the BMZ and in coordination with the other shareholders, KfW Development Bank is already observing appropriate parameters (e.g. ensuring a sufficiently high volume of financing in the long term, creating a diversified portfolio, reducing complexity by dispensing with country windows on the liabilities side). These parameters are reviewed on an ongoing basis and adjusted to achieve the best possible results.

On recommendation 2 - Define long-term exit options as part of exit strategies

This recommendation was taken up at an early stage, as KfW Development Bank established additional requirements for projects with regard to exit strategies. New funds are designed in accordance with these requirements. In this way, exit strategies are specifically anchored for newly set up funds when they are commissioned. In the case of funds set up in the past, the adjustment process takes place gradually in coordination with the other investors.

On recommendation 3 - Ensure more effective development policy control of the funds

The effectiveness of the management of the portfolio with a view to i.a. the achievement of goals and profitability is a priority for the BMZ. The BMZ is currently analyzing possible adjustments to the management model of structured funds and related investment vehicles and developing proposals for this.

On recommendation 4 - Implement abstention rules for mandate holders in the event of conflicts of interest

The BMZ attaches great importance to rule-based handling of conflicts of interest - the same applies to KfW Development Bank. The financed companies usually have adequate regulations in place. Possible conflicts of interest have so far been avoided by, inter alia, appropriate voting behavior (e.g. abstention). With regard to future appointments to mandate positions, the recommendations made by DEval in particular should continue to be given greater consideration.

On recommendations 5 and 6 - Make better use of the potential for mobilizing private funds; develop a clear acquisition strategy for private investors

The field of tension described by DEval - between the goals of sustainable management of structured funds, the acquisition of additional private funds / investors as well as market conformity on the one hand and the goals of deepening and broadening the market by expanding the financing radius to higher-risk financial intermediaries and end customers, sectors and topics on the other – bears trade-offs in shaping the structured funds.

Acquisition strategies for private investors, which are developed and implemented by the fund advisors, also move in the mentioned area of tension. Together with KfW Development Bank, the BMZ will analyze whether and which possibilities exist to exploit the potential for mobilizing additional private funds and to increase the level of ambition of the development policy goals in the selection of financial intermediaries and end customers, as suggested in recommendations 7 and 8. In detail, the level of ambition will be defined within the framework of the respective investment strategy as it will be anchored when commissioned by the BMZ.

On recommendations 7 and 8 - Use the selection of financial intermediaries more effectively to achieve the developmental impact; Link expansion of central subject areas with lending

The selection of financial intermediaries is already the central control element for ensuring sustainable, positive developmental effects. For this purpose, when the fund is set up, a decision is made on the establishment of the funding and selection criteria for financial intermediaries in coordination with the other shareholders. Accompanying measures make an important complementary contribution to improving or expanding the reach of target groups. Corresponding indicators are set at the time of establishment to check whether the target group has been reached. Together with KfW Development Bank, the BMZ will analyze which adjustments can be made to the funding and selection criteria and the sectors or target group targeting. The

above-mentioned areas of tension must be taken into account here.